



## Identifying Opportunities in the Municipal Bond Market An Excerpt of a Whitepaper from RidgeWorth Investments

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September 14, 2010

Municipal securities have earned a long-standing reputation as investments that are particularly advantageous to investors in the highest tax brackets, with benefits for those investors in middle- to low-tax brackets as well. From a historical perspective, the municipal bond market offers attractive opportunities across various economic and market landscapes for investors interested in managing their tax burden. Understanding the proven benefits of investing in municipal bonds given the current economic environment is very important.

Four key factors that fueled the rally in municipal bonds during 2009 are expected to remain center stage in 2010 and potentially in 2011:

**Budget and Credit Problems.** The majority of state and local governments survived 2009 with minor budgetary changes, although fiscal year 2010 has been slightly more challenging thus far. There is no evidence, however, of an unusual amount of bond downgrades in municipalities, with the exception of a few well-publicized states.

**Increased Tax Rates.** The current law mandates a 2010 tax reversion to levels in effect prior to 2003, unless Congress takes action. With the Obama administration's proposal of an increase in rates, even a legislative compromise is likely to raise the top brackets.

**Build America Bonds (BAB).** The Obama administration's proposal to reduce the interest subsidy on Build America Bonds from 35% to 28%, beginning in 2011, could encourage BAB issuers to accelerate issuance. The current Congressional proposal suggests a different subsidy level and includes a sunset date. The final proposal is unknown at this time.

**Low Money Market Yields.** Near zero returns on money market funds are expected to continue. As a result, we anticipate investors with excess cash will continue to be directed toward tax-exempt bond funds despite currently low yields.

While current economic conditions are exerting pressure on the municipal bond market, favorable high-credit quality opportunities exist for those municipal bond investors who invest carefully and selectively.



## HISTORICAL PERSPECTIVE

Municipal bonds historically have been among the most desirable and advantageous investments for the highest tax bracket investors interested in:

- Minimizing their income tax burden
- Holding an asset class with a dependable income stream that is not highly correlated with the returns and volatility of equity securities

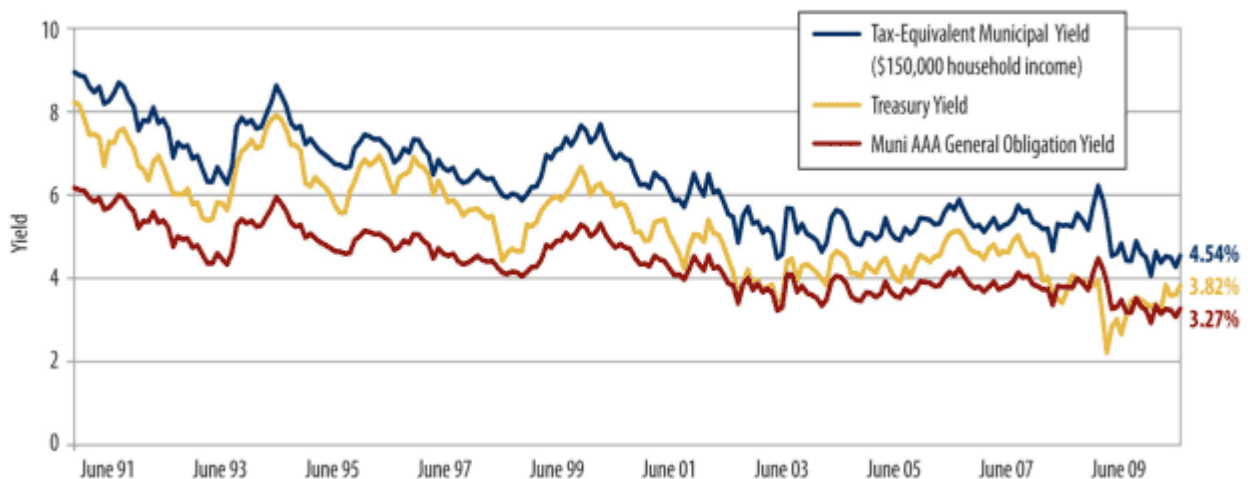
Municipal investing, however, is not reserved solely for the wealthiest investors. In fact, municipal securities can also benefit the average investor.

Consider an investor with a current marginal tax rate of 28% who, with a comparable income level 30 years ago, would have been in a higher tax bracket of 54%. This rate decline might have led this investor to underestimate the value of tax-exempt bonds in an overall investment strategy. Exhibit 1 shows that since 1991, however, the tax-equivalent yield of a high quality municipal bond for such an investor has exceeded the yield on Treasury bonds of the same maturity. Notably, the tax-equivalent yield for investors in higher tax brackets was even greater. **Visit [ridgeworth.com/muni-bonds](http://ridgeworth.com/muni-bonds) to compare the tax-equivalent yield on municipal bonds across select income levels since 1991.**

Today's personal income tax brackets, which have been in effect since 2003, are set to expire at the end of 2010, unless otherwise directed by legislation. In the likely event they expire, the top Federal tax bracket will increase from 35% to 39.6% in 2011. Basically, the higher an investor's tax bracket, the higher the taxable-equivalent yield of municipal securities currently held. However, in anticipation of a tax rate increase, yields on tax-exempt bonds have declined relative to their taxable bond counterparts in recent months.

### EXHIBIT 1: Comparison of Municipal Yield vs. Treasury Yields

June 1, 1991 - March 31, 2010





Source: Bloomberg, The Tax Foundation. Yields represent bonds with 10-year maturities, June 1991 - March 2010. Past performance does not guarantee future results. Tax-equivalent yield is a calculation used to compare the yield of a municipal bond to the yield of a taxable bond. The 10-year Treasury Yield measures the yield of U.S. government issued Treasury Bonds with 10-year maturities. The Municipal AAA General Obligation Yield is the composite yield of municipal securities with maturities of around 10 years.

## Key Benefits of Investing in Municipal Bonds

Obtaining tax-free income is the primary benefit of owning a portfolio of municipal bonds; however, other advantages to holding these securities include:

### Low Default Rates

Municipal bonds historically have experienced low default rates compared to corporate bonds. Exhibit 2 illustrates that the 10-year average cumulative default rate for municipal bonds since 1970 was 0.09% versus 11.06% for corporate bonds. This relative security can be attributed largely to the fact that most municipal bonds are issued to finance infrastructure owned by state and local governments. The funding for repayment of these bonds is provided from:

- Taxes levied on real estate, retail sales and income
- Usage fees for services such as water, sewer and toll roads

Bonds secured by the pledge of a government unit to use all available resources to service the debt, are considered general obligation bonds. Bonds secured by the pledge of a fee for the service provided by a specific facility are typically known as revenue bonds. Both types of bonds, often referred to as governmental purpose bonds, are considered the most secure in the tax-exempt universe.

## EXHIBIT 2: 10-Year Average Cumulative Default Rates for Municipal and Corporate Bonds 1970 – 2009

RATING	MUNICIPAL	CORPORATE
Aaa	0.00%	0.50%
Aa	0.03%	0.54%
A	0.03%	2.05%
Baa	0.16%	4.85%
Ba	2.80%	19.96%
B	12.40%	44.38%
Caa	11.60%	71.38%
All Investment Grade	0.06%	2.50%
All Speculative Grade	4.55%	34.01%
All Rated	0.09%	11.06%

Source: Moody's Investors Services, February 2010. Past performance does not guarantee future results. Note: For any rating category, the percentage shown is the cumulative total of the bonds defaulting over 10 years. The Municipal column includes general obligations and non-general obligations. The general obligation default percentage is almost zero in all rating categories. Moody's database of corporate defaults covers over 3,600 long-term bond defaults by issuers. The figures do not include bonds that were not rated at the time of issuance. Rating agencies such as Moody's, rates securities from Aaa (highest quality) to C (lowest quality) with Baa and above being called investment grade securities. Ba and below are considered below investment grade (speculative) securities.



## Low Price Volatility

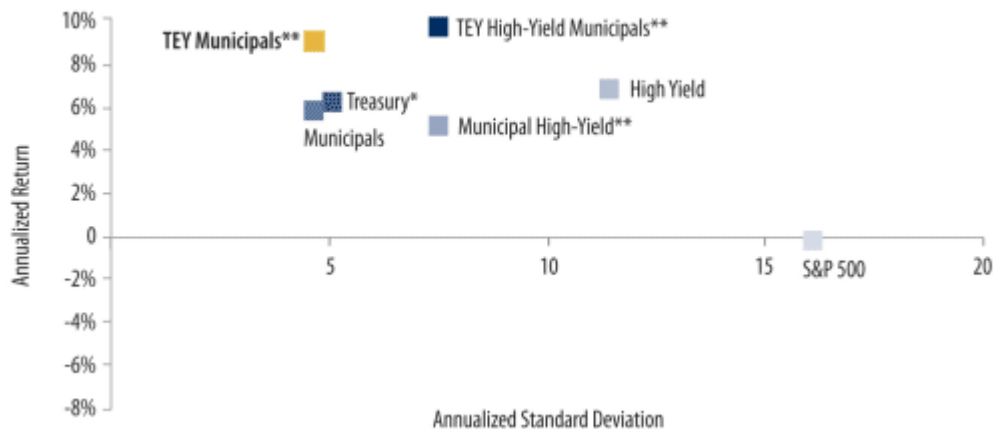
Following the demise of some major financial institutions in 2008, price volatility in all credit markets increased dramatically in 2009—and has continued in early 2010. The volatility of fixed income securities can stem from the changing “risk premium” as securities trade at varying spreads to “riskless” U.S. Treasuries. Other factors that may affect price volatility include changes in interest rates, shifts in the yield curve and call features.

According to the chart below, municipal bonds have generally offered lower volatility relative to taxable fixed income and equities. Volatility can be measured by the:

- Average daily price change of a single security or an index
- Annualized return of the same security or index compared to the returns of a different security or index over the same time period

Exhibit 3 presents a comparison of tax-equivalent returns and volatility of municipal bonds relative to other asset classes over a 10-year period. The chart illustrates that the tax-equivalent return of municipal bonds was higher than the returns for all asset classes except tax-equivalent high yield municipal bonds and that the volatility of tax-equivalent municipal bonds was in line with Treasuries.

**EXHIBIT 3: Tax-Equivalent Returns and Volatility of Municipal Bonds vs. Other Asset Classes**  
10-Years Ending February 28, 2010



Source: Barclays Capital. Past performance does not guarantee future results.

TEY = Taxable Equivalent Yield, S&P 500 Index = Equities, Municipals = Barclays Municipal Index, High Yield = Barclays Corporate High Yield Index, Treasury = Barclays Treasury Bond Index, Municipal High Yield = Barclays Municipal High Yield Index

\* U.S. Treasury Income returns are exempt from state income taxes and are adjusted (3.25% in 2002-2009, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of Federal income tax.

\*\* Based on an equally weighted nationally average federal and state (top bracket) income tax rate (38.48% in 2009, 38.45% from 2003-2008, 41.85% for 2002, 42.33% for 2001, 42.78% prior); local taxes have not been considered in analysis.



### **Diversification**

Municipal bond returns are not highly correlated with equity markets, offering diversification that helps smooth volatility of a total portfolio. A fixed income portfolio invested in corporate and government bonds can be diversified further with municipal bonds.

The universe of municipal bonds is expansive—available from thousands of bond issuers across 50 states and the District of Columbia, as well as Puerto Rico, Guam and the U.S. Virgin Islands. Not all states tax municipal bonds at the same rate, and bonds with the same quality and rating often trade at different yields. Therefore, an investor often can invest in bonds from states other than their state of residence and receive a comparable return, even if the out-of-state bond is subject to state tax. In addition to geographic diversification, bonds are available in a variety of sectors as described earlier.

Diversification is provided—in varying degrees—by sensitivity to economic conditions across sectors of governmental and private activity finance, with some revenue bonds as secure as general obligation bonds.

### **Attractive Total Returns**

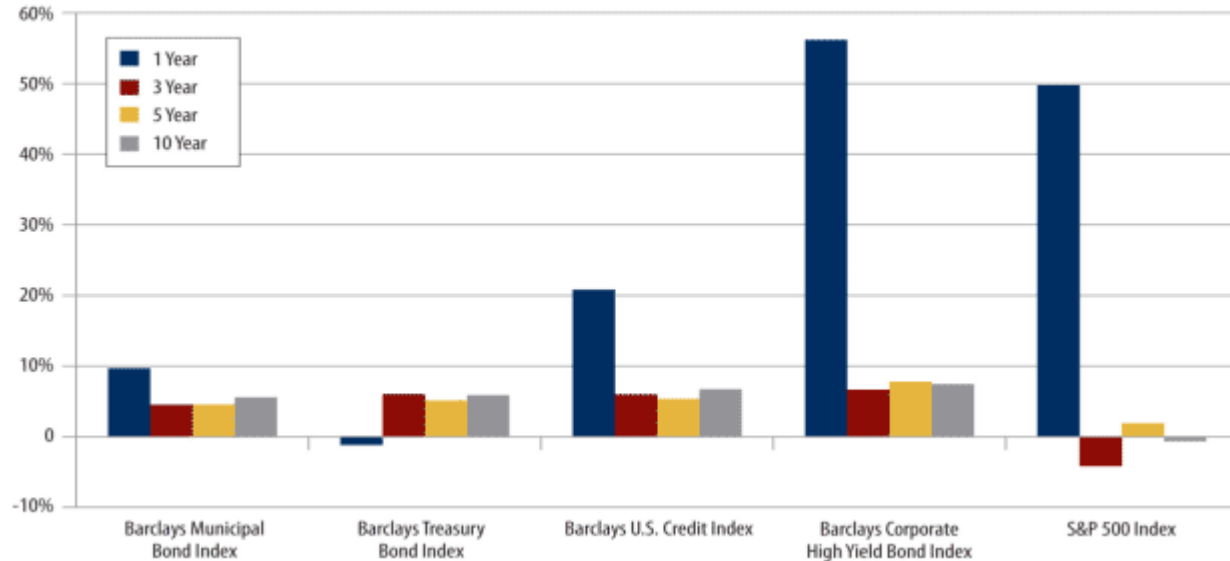
Equity markets have generated disappointing returns during the last decade, as measured by the S&P 500 Index. 2009 offered a reprieve in the equity markets, however, investors are attempting to rebuild their portfolios and preserve capital through investment in diverse asset classes, including municipal bonds.

Exhibit 6 shows the annualized returns of municipal bonds relative to equities and other bond sectors. Last year, municipal bonds outperformed equities for the 3-, 5- and 10-year time periods.



## EXHIBIT 6: Fixed Income and Equity Returns Since 2000

Ending March 31, 2010



Source: FactSet. Past performance does not guarantee future results.

## OUTLOOK FOR 2010 (and Potentially 2011)

A number of factors affecting municipal bonds last year are expected to remain front and center in 2010 including:

### Budget and Credit Problems

*Expectation: Persist; Possible Increase*

As fiscal year 2009 (June 30 ending for most states) unfolded and the Great Recession continued, state and local governments were plagued with budget problems. While most entities survived the year with no severe budgetary changes, fiscal years 2010 and 2011 are expected to be more tumultuous. However, no evidence of an unusual amount of municipal bond downgrades has surfaced during the first quarter 2010, with the exception of a few well-publicized states.

Rating agencies expect states to adjust spending to balance with revenues as required by virtually every state's constitution. More significantly, debt service is given top repayment priority in most states. The ability of most state and local governments to cover debt service is not at risk, as it represents less than 10% of expenditures. In many cases, debt is paid from dedicated revenue sources such as fees from water and sewer services. Nevertheless, negative headlines surrounding public finance are likely to affect both the pricing and the liquidity of bonds from the most stressed issuers.



Personal income and sales taxes are the largest revenue sources for most states and collections are down from prior years—and even lower than recently revised forecasts on which current year budgets were planned. As long as unemployment remains near 10%, major revenue streams are not likely to expand in the near term. At the local level, where property taxes are typically the largest revenue source, home values are under pressure, adversely impacting city and county revenues.

### **Tax Rates**

#### *Expectation: Increase*

Several states, with acute revenue shortfalls, have raised personal income tax rates. Others are likely to follow suit in an effort to raise revenue. The revisions to revenue projections have been fueled by the severity of the recession, high unemployment and consumer retrenchment.

The Federal government's unbalanced budget and the 2010 sunset of personal income tax rates provide a convenient opportunity to propose higher tax rates in an attempt to lower future deficits. As mentioned, with the current law tax rates will revert to rates in effect prior to 2003.

The Obama administration has proposed higher rates, and therefore, it is highly likely that even a legislative compromise will raise the top tax brackets.

With an increase in tax rates, all tax-exempt bonds will have a higher taxable-equivalent yield and bonds sold in the future will sell at higher prices than if taxes had not increased. Following is the conversion calculation, using a 5% tax-free yield (available on some A-rated revenue bonds) and adjusting the top Federal bracket from 35% to 39.6%. The formula excludes the impact of state income taxes that vary by state and may further improve the taxable-equivalent yield.

$$\text{Taxable-equivalent yield} = 5\% \times 1 / (1 - 0.350) = 7.69\%$$

$$\text{Taxable-equivalent yield} = 5\% \times 1 / (1 - 0.396) = 8.28\%$$

### **Build America Bonds**

#### *Expectation: Supply Increase*

The volume of taxable BAB likely will be higher in 2010 than in 2009 because these bonds were available only nine months in 2009, and issuers are expected to take advantage of this borrowing option. Taxable bond market investors adjusted quickly to another sector in which to invest, and taxable municipal bonds are pricing at tighter spreads to Treasuries compared to the time in which they were first marketed.

The Administration's proposal to reduce the interest subsidy from 35% to 28%, beginning in 2011, could motivate BAB issuers to accelerate issuance. However, debt capacity is constrained for governments with lower revenues. Many will need to delay—not rush—capital projects and debt burden. Regardless of the subsidy, governments must budget to



repay debt. More prudently managed state and local governments will issue debt in amounts that will neither threaten their ratings nor consume revenue needed for ongoing services.

In recent years, prior to the advent of BAB, state and local governments have issued over \$400 billion annually in tax-exempt bonds. Nearly one-third of that amount may be issued as taxable bonds in 2010 and beyond, representing a permanent reduction in the supply of tax-exempt bonds.

### **Low Money Market Yields**

*Expectation: Remain Low*

Money funds continue to lose assets, with a significant portion of this cash flowing into a variety of longer-term fixed income securities. Combined with the annual receipt of principal and interest on outstanding municipal bonds—estimated to average \$33 billion per month this year—demand for the future supply of tax-exempt bonds is tremendous.

During the first 11 months of 2009, the record flow of funds into municipal bond funds—over \$70 billion—was comparable to assets lost from tax-exempt money market funds of slightly over \$75 billion. Moving forward, we believe a portion of these assets will continue to be directed toward tax-exempt bonds despite record low yields currently available.

## **CONCLUSION**

In 2009, high-grade municipal bonds offered investors an extraordinary opportunity to obtain yields at a historically high ratio relative to Treasuries. Market and economic conditions today are dramatically different from a year ago, however, the municipal market still offers attractive investment opportunities.

When considering municipal investing, investors should understand that current yields reflect the anticipation of higher tax brackets and lower supply of tax-free bonds. Investors in the low- and middle-tax brackets may want to consider both taxable and tax-free bonds, particularly investors with a very short maturity focus. If brackets become more progressive, investors in the top brackets should find yields attractive, while lower bracket investors may not consider them as attractive as before, particularly if the cross market ratio drops much lower.

Municipal bond yields reached extremely low ratios during the first quarter of 2010, but have since moderated and become more advantageous. However, the high-grade nature of the available securities remains a key selling point for investors concerned about credit quality. Amid pressures from the recession, the three major rating agencies have issued relatively few rating changes. In fact, all three agencies have acknowledged that municipal bond issues likely deserve slightly better ratings in the context of both historic default rates and recovery levels following default relative to the issuers of corporate bonds.



Two of the agencies, Moody's and Fitch, have recently announced a "remapping" of their rating scale for municipal bonds, which will result in higher ratings on many general obligation and essential service revenue bonds. The rating agencies are intensely aware of the budgetary challenges presented by lower sales, personal income and property tax revenues. They also are cognizant of another popular topic among critics of public finance, which is the analysis of funding deficiencies of public pension systems. This long-term issue will require decades to play out and therefore, presents no imminent threat to the solvency of state and local governments.

Investors should anticipate that cross-market relationships will naturally ebb and flow during the year. Given current conditions and the uncertainty of the economic landscape, investors are advised to seek actively managed municipal bond mutual funds managed by seasoned investment professionals who have experience navigating tumultuous market environments and have the potential to provide competitive after-tax total return.

While the current credit environment is challenging, we believe the municipal market still offers sound investments for those investors who invest carefully and selectively.

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## Disclosures

### **Past performance does not guarantee future results.**

Bond investors should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. Indexes are unmanaged and investors cannot invest directly in an index. The yields illustrated do not represent any RidgeWorth Fund. A tax-exempt municipal bond's income may be subject to certain state and local taxes and, depending on an investor's tax status, the federal alternative minimum tax. RidgeWorth does not provide tax advice. Please consult your tax advisor for your particular situation.

Rating agencies such as Moody's, rates securities from Aaa (highest quality) to C (lowest quality) with Baa and above being called investment grade securities. Ba and below are considered below investment grade (speculative) securities.

*This paper reflects the analysis and opinions of RidgeWorth Investments as of May 2010. Because market and economic conditions are often subject to rapid change, the analysis and opinions provided may change without notice. The analysis and opinions may not be relied upon as investment advice.*

*Statements of fact are from sources considered reliable but no representation or warranty is made as to their completeness or accuracy. Although historical performance is no guarantee of future results, these insights may help you understand our investment management philosophy.*

*In preparing this paper, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from reliable sources.*



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**10-year Treasury Yield** measures the yield of U.S. government issued Treasury Bonds with 10-year maturities.

**S&P 500 Index** is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market.

**Barclays Municipal Bond Index** is considered to be generally representative of investment-grade municipal issues having maturities greater than one year and a national scope.

**Barclays Municipal High Yield Index** is composed of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

**Barclays Treasury Bond Index** is composed of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

**Barclays Corporate High Yield Bond Index** is composed of issues that meet the following criteria: at least \$150 million par value outstanding, maximum credit rating of Ba1 (including defaulted issues) and at least one year to maturity.

**Barclays U.S. Credit Index** includes all publicly issued, fixed-rate, non-convertible, investment-grade, dollar-denominated, SEC-registered corporate debt. All issues have at least one year to maturity and outstanding par value of at least \$250 million.

**Cross-Market Ratio** is a ratio used to compare yields across fixed income sectors.

**Municipal AAA General Obligation Yield** is the composite yield of municipal securities with maturities of around 10 years.

**Standard Deviation** is a statistical measurement of dispersion about an average, which depicts how widely returns varied over a certain period of time.

**Tax-Equivalent Yield** is a calculation used to compare the yield of a municipal bond to the yield of a taxable bond.

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